DEPARTMENT OF STATE REVENUE

01-20170939.LOF

Letter of Findings: 01-20170939
Income Tax
For the Years 2012, 2013, 2014, and 2015

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Businesses and their Shareholders failed to demonstrate that Businesses conducted qualified research activities. The documents offered by Businesses and their Shareholders did not clearly establish that Businesses and their Shareholders were entitled to the Indiana Research Expense Credits.

ISSUE

I. Individual Adjusted Gross Income Tax - Burden of Proof.

Authority: I.R.C. § 41; IC § 6-3-2-1; IC § 6-3-1-3.5; IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Scopelite v. Indiana Dep't of Local Gov't Fin.,* 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue,* 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Suder v. Comm'r,* T.C. Memo. 2014-201 (T.C. 2014); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); Treas. Reg. § 1.41-4; Treas. Reg. § 1.174-2; Treas. Reg. § 1.6001-1; IRS, *Audit Technique Guide*, 2005 WL 4057831 (June 2005).

Shareholders of two S corporations argued that they were entitled to claim the Indiana research expense credits because their two companies conducted qualified research activities.

STATEMENT OF FACTS

Taxpayers (Husband and Wife) are the owners and shareholders of two S corporations, which produce metal parts for a variety of customers. One is a metal fabrication plant and the other is a metal stamping plant. As shareholders of both companies, Taxpayers reported and claimed the companies' "flow-through" credits on their individual income tax returns. In 2015, a third-party consulting firm was engaged to perform a research and development tax credit study for 2011, 2012, 2013, 2014, and 2015 tax years. The consulting firm produced three written reports ("Studies") which were used to claim Indiana Research Expense Credits ("RECs").

In 2016, The Indiana Department of Revenue ("Department") audited the business records and tax returns of Taxpayers and both companies (*collectively*, "Taxpayers") for the tax years 2012, 2013, 2014, and 2015 tax years ("Tax Years at Issue"). The Department disallowed Taxpayers' RECs on the ground that Taxpayers were not entitled to claim the RECs pursuant to the audit.

Taxpayers protested. An administrative hearing was conducted during which Taxpayers' representatives explained the basis for the protest. Taxpayers requested additional time to submit additional supporting documentation. This Letter of Findings results. Further facts will be provided, as necessary.

I. Individual Adjusted Gross Income Tax - Burden of Proof.

DISCUSSION

Pursuant to the audit, the Department disallowed Taxpayers' claimed RECs, determining that Taxpayers' activities (1) did not meet the definition of and (2) were excluded from "qualified research" under I.R.C. § 41. Specifically, the audit found that Taxpayers claimed 80 percent of wages paid to each and all of their employees who worked

in the "Tool Room" and 80 percent of wages paid to their Engineering Manager as qualified research expenses without substantiating the qualified research activities those individuals performed for the Tax Years at Issue. The audit concluded that Taxpayers did not provide sufficient and verifiable supporting documents to substantiate the amount of time and expenses during which Taxpayers' employees were purportedly engaged in activities which met the definition of "qualified research." The audit also could not apply the "shrinking-back" rule because of insufficient supporting documentation.

Taxpayers disagreed, claiming that the Department erroneously disallowed their RECs. Thus, the issues are whether Taxpayers conducted qualifying research activities, whether Taxpayers can document the extent to which Taxpayers' employees conducted those qualifying activities, and whether Taxpayers were also entitled to claim those expenses.

As a threshold issue, it is a taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012). Thus, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.,* 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue,* 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to an agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014).

Indiana follows the federal tax scheme with certain modifications. IC § 6-3-2-1(b); IC § 6-3-1-3.5(b). Indiana also provides certain tax credits which a taxpayer may claim to reduce its tax liability. One of the tax credits available for the Tax Years at Issue under Indiana tax law is the RECs under IC § 6-3.1-4-1 *et seq.* which was effective until December 31, 2015, provides:

> The provisions of Section 41 of the Internal Revenue Code as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period. IC § 6-3.1-4-4.

I.R.C. § 41(d)(1) defines "qualified research" is research -

> (A) with respect to which expenditures may be treated as specified research or experimental expenditures under section 174,
> (B) which is undertaken for the purpose of discovering information--
> (i) which is technological in nature, and
> (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
> (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).
>
> Such term does not include any activity described in paragraph (4).

In other words, under I.R.C. § 41(d)(1), "qualified research" is research that meets the above distinct four tests and cannot be activities outlined under I.R.C. § 41(d)(4), as follow:

> **(A) Research after commercial production.** Any research conducted after the beginning of commercial production of the business component.
> **(B) Adaptation of existing business components.** Any research related to the adaptation of an existing business component to a particular customer's requirement or need.
> **(C) Duplication of existing business component.** Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.
> **(D) Surveys, studies, etc.** Any
> (i) efficiency survey,

(ii) activity relating to management function or technique,
(iii) market research, testing, or development (including advertising or promotions),
(iv) routine data collection, or
(v) routine or ordinary testing or inspection for quality control.

(E) Computer software. Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in--

(i) an activity which constitutes qualified research (determined with regard to this subparagraph), or
(ii) a production process with respect to which the requirements of paragraph (1) are met.

(F) Foreign research. Any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

(G) Social sciences, etc. Any research in the social sciences, arts, or humanities.

(H) Funded research. Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

(**Emphasis in original**).

Each of the above tests must be applied separately to first at the level of the discrete business component. If a business component as a whole fails one of the tests, the "shrinking-back rule" could be applied pursuant to Treas. Reg. § 1.41-4(b)(2).

In order to obtain the benefit of the credit, both Indiana and federal law require that a taxpayer maintain and produce *contemporaneous* records sufficient to verify those credits. "Tax credits are a matter of legislative grace, and taxpayers bear the burden of proving they are entitled to claim tax credits." *Suder v. Comm'r,* T.C. Memo. 2014-201, 12-13 (T.C. 2014).Moreover, where such a credit is claimed, "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)). "Tax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." *United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009)(citing *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000)).

Under IC § 6-8.1-5-4 "Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability. . . ." In addition, Treas. Reg. § 1.41-4(d)(1) (2001) states that for taxpayer to receive the research and development tax credit, a taxpayer must:

> Prepare[] documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed [] for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) satisfies section 6001 and the regulations thereunder.

The IRS's *Audit Technique Guide*, 2005 WL 4057831 (June 2005) provides useful guidance in relation to the information necessary to verify research expense credits. The Guide states:

> **7. SUBSTANTIATION AND RECORD KEEPING**
> Under the final regulations, ***a taxpayer must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit.*** *See* I.R.C. § 6001; Treas. Reg. § 1.6001-1. The taxpayer must clearly establish full compliance with all of the relevant statutory and regulatory requirements. Failure to maintain records in accordance with these rules is a basis for disallowing the credit. The Service does not have to accept estimates of qualified research expenses if documentation exists to verify the actual amount of such expenses. As set forth above, taxpayers are required to keep records substantiating the amount of any reported, claimed, or affirmatively raised deductions or credits.
>
> The courts will allow the use of an estimation method only where the taxpayer does not have contemporaneous records, and then only as long as the following two conditions are satisfied. First, the taxpayer must establish that it engaged in qualified research activities as defined in section 41(d). And second, the failure to maintain a proper system to capture relevant information cannot be an "inexactitude [] of their own making." ***Estimation methods are permitted only in cases where the sole issue is the exact amount paid or incurred in the qualified research activity. Accordingly, taxpayers must have factual***

> ***support for every assumption underlying their estimates to meet their burden of proof.***
>
> 2005 WL, at *24. *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping*, available at https://www.irs.gov/businesses/audit-techniques-guide-credit-for-increasing-research-activities-ie-research-tax-credit-irc-ss-41-substantiation-and-recordkeeping (last visited April 22, 2021) (**Emphasis in original**) ***(Emphasis added).***

Thus, while estimation methods can be permissible when computing the amount of the RECs, those estimates must be backed by documentation which verifies the amount of the expense. To reiterate the IRS' guidance, "[T]axpayers must have factual support for every assumption underlying their estimates to meet their burden of proof."

A. The Audit.

The Department's audit in this instance noted that Taxpayers claimed the RECs based on the Studies prepared by the consulting firm. The audit found that the consulting firm primarily relied on interviews with one owner and one engineering/purchasing manager of Taxpayers to produce the Studies in question. The Studies in question stated that Taxpayers spent approximately $4.5 million dollars on their "qualified research expenses" during the Tax Years at Issue.

The Department repeatedly requested that Taxpayers substantiate their claim that their employees conducted qualified research activities. Taxpayers failed to do so. As a result, the audit concluded that Taxpayers' activities did not meet the four tests required under I.R.C. § 41(d) which defines "qualified research" as research:

> 1. With respect to which expenditures may be treated as expenses under section 174[;]
> 2. Which is undertaken for the purposes of **discovering information** and which is technological in nature [also known as the Discovery Test[;]
> 3. The application of which is intended to be useful in the development of a **new or improved business component** of the taxpayer; and
> 4. **Substantially all of the activities which constitute elements of a process of experimentation for a [qualifying purpose]**.
>
> (**Emphasis added**).

I.R.C. § 41(d) sets out this four-pronged test for verifying qualified research activities. First, the research must have qualified as a business deduction under I.R.C. § 174. I.R.C. § 41(d)(1)(A). Second, the research must be undertaken to discover information "which is technological in nature." I.R.C. § 41(d)(1)(B)(i). Third, the taxpayer must intend to use the information to develop a new or improved business component. I.R.C. § 41(d)(1)(B)(ii). Finally, the taxpayer must pursue a "process of experimentation" during substantially all of the research. I.R.C. § 41(d)(1)(C).

1. Section 174 Business Deduction.

The audit found that Taxpayers' expenditures did not meet the first test - verifying qualified research and experimental expenditures - based on the definition set out in Treas. Reg. § 1.174-2 which states in part:

> The term research or experimental expenditures, as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represents research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. . . . Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the products.

The audit found that Taxpayers did not track and made no designation on their federal income tax returns that any research expenses incurred by their employees under I.R.C. § 174.

The audit further found that all expenses claimed by Taxpayers were deducted as "ordinary and necessary business expenses under I.R.C. § 162." Taxpayers were unable to substantiate the amounts claimed. The audit

thus concluded that Taxpayers' activities did not meet the first test under section 174.

2. Discovering Technological Information.

The Department cited to Treas. Reg. § 1.41-4(a)(3)(i) of the 2001 Final Regulations which states:

> For purposes of section 41(d) and this section, research is undertaken for the purpose of **discovering information** only if it is undertaken to obtain knowledge that exceeds, expands, or **refines the common knowledge** of skilled professionals in a particular field of science or engineering. T.D. 8930, 66 F.R. 280-01 at 290. (**Emphasis added**).

The Department's audit found that Taxpayers have been "in business for over 50 years" and have produced metal parts and tooling for customers in a variety of industries. As such, Taxpayers' employees have "years of experience in engineering and metal production." The audit found that the activities of Taxpayers' employees were "not seeking information that exceeds, expands or refines the common knowledge of skilled professionals in the field of science or engineering." Rather, they were "using common, commercially available and proven manufacturing equipment and processes." The audit determined that "the information being sought by [Taxpayers] is common knowledge to skilled professionals in the metal stamping/production field and not qualified research."

Alternatively, the audit also analyzed Taxpayers' activities under Treas. Reg. 1.41-4(a)(3) (T.D. 9104) and rejected Taxpayers' contention. In other words, Taxpayers failed to substantiate (1) that the information available to Taxpayers established the capability or method for developing or improving their business component(s) or the appropriate design of their business component(s) and (2) that they conducted research activities, discovering information, which was necessary to eliminate "uncertainties" concerning these business components.

The audit determined that Taxpayers' activities failed the second test, research undertaken for the purpose of discovering information which is technological in nature.

3. New or Improved Business Component.

As to the third of the four tests - the Business Component Test - a taxpayer must intend that the information to be discovered during its research will be useful in the development of a new or improved business component of the taxpayer. I.R.C. § 41(d)(1)(B)(ii). A "business component" is a product that the taxpayer either holds for sale, lease, or license or uses in its trade or business. I.R.C. § 41(d)(2)(B). For purposes of this test, the taxpayer must identify the business components for which it claims qualified research activities.

In this instance, Taxpayers declined to identify their business components and responded that they did not document and track their activities. Thus, Taxpayers were unable to substantiate each business component they claimed. The audit thus determined that Taxpayers failed to meet the third test that they intended to use the information to develop a new or improved business component.

4. Undertaking a Process of Experimentation.

Finally, as to the fourth test, the audit referred to Treas. Reg. § 1.41-4(a)(5) (T.D. 8930) which states in part:

> A process of experimentation is a process to evaluate more than one alternative designed to achieve a result where the capability or method of achieving that result is uncertain at the outset. A process of experimentation does not include the evaluation of alternatives to establish the appropriate design of a business component, if the capability and method for developing or improving the business component are not uncertain.

The audit also cited to Treas. Reg. 1.41-4(a)(5)(a) (T.D. 9104) which provides in part:

> A process of experimentation must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science and involves the identification of uncertainty concerning the development or improvement of a business component, the identification of one or more alternatives intended to eliminate that uncertainty, and the identification and the conduct of a process of evaluating the alternatives (through, for example, modeling, simulation, or systematic trial and error methodology). A process of experimentation must be an evaluative process and generally should be capable of evaluating more than one alternative.

Based on the information provided, the audit found that Taxpayers failed to meet the "experimentation" standard under either the "discovery" or "uncertainty" tests.

In addition, the audit determined that Taxpayers' activities, such as "tooling up for production" and "trial production runs" were excluded under I.R.C. § 41(d)(4). The audit further concluded that "shrinking back" rule was not applicable because Taxpayers did not provide verifiable documentation necessary which would have allowed the Department to apply the four tests to the subset of their business components' elements.

B. Taxpayers' Response.

Throughout the protest process, Taxpayers contended that the Department erred in disallowing their RECs for the Tax Years at Issue. Taxpayers argued that the Department should have applied the uncertainty test and that they were not required to provide verifiable supporting documents to substantiate their qualified research expenses. In addition to the Studies in question, Taxpayers provided several photos of their presses, asserting that the projects regarding (1) Press for Railroad Deck Boards, (2) Railroad Doors, and (3) rear doors to trailers, established that Taxpayers conducted qualified research activities. Taxpayers further contended that the Studies in question sufficiently supported the estimated $4.5-million-dollar qualified research expenses.

C. Analysis and Conclusion.

Upon review, Taxpayers' reliance on the Studies in question is misplaced. Taxpayers in this instance sought to claim Indiana RECs, a tax credit. As such, Taxpayers bear the burden of proving that they were entitled to claim the tax credit for the Tax Years at Issue. Taxpayers thus are required to demonstrate that their activities satisfied *each and all* the four tests and their activities were not excluded under I.R.C. § 41(d)(4).

In this instance, Taxpayers claimed RECs on expenses including wages and supplies but "made no designation . . . that any research expenses were incurred" pursuant to I.R.C. § 174. That is, Taxpayers were unable to demonstrate the expenses "incurred in connection with [their] trade or business which represents research and development costs in the experimental or laboratory sense." Rather, the expenses in question were deducted by Taxpayers as ordinary and necessary business expenses under I.R.C. § 162. Taxpayers failed to meet the first of the four tests.

In addition, Taxpayers were required to substantiate their business components for which they claimed qualified research activities. Taxpayers' documentation simply summarized Taxpayers' projects without identifying their business components and demonstrating the technological information they intended to discover. Thus, Taxpayers failed the second and the third tests.

Taxpayers' documents further showed that Taxpayers claimed 100 percent of wages paid to their employees, such as individuals who worked in the Tool Room. According to the Studies, those employees "directly supported the research and development process to manufacture custom products during the Study period." Taxpayers, however, declined to offer any supporting documents to substantiate (1) that the activities in question performed by those individuals connecting to each "new or improved business component," (2) that the activities in question discovered information that was technological in nature and (3) the activities in question met the "process of experimentation" test, which requires "substantially all of the research activities constitute elements of a process of experimentation for a qualified purpose."

Even if, for the purpose of argument, assuming that Taxpayers identified the three projects as their business components, Taxpayers failed to substantiate they met the test of discovering technical information and the test of "undertaking a Process of Experimentation." Specifically, Taxpayers are required to provide verifiable supporting documents to substantiate the following: (i) the "substantially all" element, (ii) the "process of experimentation" element, and (iii) the "qualified purpose" element. Taxpayers did not do so. Since Taxpayers could not substantiate the above elements, Taxpayers erred in claiming 100 percent of wages paid to those individuals who worked in the Tool Room as qualified research expenses - either in the denominator or otherwise - to compute their Indiana RECs.

As mentioned earlier, in addition to the failure to meet the above tests, the audit determined that Taxpayers' activities in question were excluded from qualified research activities under I.R.C. § 41(d)(4). Taxpayers' activities, including tooling up for production and trial production runs, were deemed activities conducted after the beginning of commercial production. Taxpayers did not provide any supporting documentation to demonstrate otherwise. Therefore, this issue is moot. Taxpayers could not claim the RECs because their activities were excluded activities pursuant to I.R.C. § 41(d)(4).

Finally, the shrinking-back rule is not applicable in this instance because Taxpayers did not offer any information to support the application of shrinking back rule - shrinking back to the next available business component or components.

In conclusion, given the totality of the circumstances, in the absence of other verifiable supporting documentation, the Department is not able to agree that Taxpayers met their burden of proof demonstrating that the Department's assessments were incorrect.

FINDING

Taxpayers' protest is respectfully denied.

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